



FORT SAM HOUSTON LEGAL ASSISTANCE OFFICE

Using Trusts in Estate Planning

Testamentary Trusts

A. Created by Will

As a testamentary instrument, a will may create a trust by leaving property to a trust that will be managed by a trustee for the benefit of named beneficiaries. This is a testamentary trust and takes effect on the death of the person establishing the trust. Distinguished from a testamentary trust is an inter vivos or living trust, which is a trust created while the trust founder is still alive.

A testator, the person making the will, may wish to create a testamentary trust for many reasons, including the following:

1. To appoint a trustee who will provide for close supervision, competent management, and preservation of the trust assets when minor children are the potential beneficiaries.
2. To provide for regular payments to persons named as income beneficiaries of the trust.
3. To provide for flexibility in distributing income and principal to the beneficiaries of the trust.
4. To provide for preservation of trust assets for future distribution to the persons designated to receive the remainder of the trust assets.
5. To minimize estate taxation by maximizing the application of the unified credit or make split-interest charitable dispositions.
6. To care for a person with disabilities after the death of the testator

B. Testamentary Trust as Unified Credit Trust

Testamentary trusts are often used in estate planning for married couples whose combined estates exceed the value of the applicable credit amount (\$ 1.5 million for 2004 and 2005, \$ 2 million for 2006, 2007 and 2008, and \$ 3.5 million for 2009) that eliminates federal estate tax through the application of the unified credit.

Under this plan a testamentary trust, called a *unified credit trust* or *bypass trust*, is created by each will of a husband and wife to receive an amount from the decedent's estate equal to the applicable

credit amount. Property transferred to the trust uses the unified credit of the first spouse to die and still allows that estate to pass without tax if all other assets are left to the surviving spouse.

The following example illustrates use of a bypass trust:

If a husband and wife in Texas have a combined \$3.5 million in assets, each of them will be treated under our community property laws as owning half, or \$1.75 million. If the husband were to leave his \$1.75 million directly to his wife, there would be no estate tax because of the unlimited marital deduction, but when she dies later, her estate would be valued at the full \$3.5 million (assuming no change in value). This year, the estate tax on a \$3.5 million estate is \$945,000.

A bypass trust can sharply reduce this tax.

Rather than transferring \$1.75 million to his wife outright, the husband could instead transfer \$1.5 million of it to a bypass trust created in his will or revocable trust. The \$1.5 million corresponds to the exemption available this year. Upon the husband's death the spouse will have unlimited access to the income from the \$1.5 million placed in trust. The spouse also has access to the principal of the trust as required for her health, education, maintenance and support.

In 2006 and later, the husband will be able to place more in the bypass trust if the exemption is higher in the year of his death. Of course, if the exemption is lower, then the bypass trust would be lower too. The benefit is that the wife would have a taxable estate of only \$2 million because the bypass trust would not be included in her estate. The tax this year on a \$2 million estate is \$225,000, a savings of \$720,000.

C. By-Pass Disclaimer Trust

To create this kind of trust the will first makes an outright gift of all the desired property to the surviving spouse followed by an express provision that any property that the surviving spouse disclaims passes into a bypass trust for the surviving spouse's benefit.

A qualified disclaimer of a bequest occurs when a beneficiary declines to accept property left to him under a will. To properly make a disclaimer, the person refusing the property must deliver in writing, a refusal of the property, to the legal representative of the deceased within nine months after the day the transfer is made. The refusal will fail if the person refusing the property has accepted it or any benefits flowing from it before making the disclaimer.

The benefit gained by utilizing a by-pass disclaimer trust is that the surviving spouse has the ability to evaluate her financial situation at the time of her husband's demise and can structure assets in a manner that best meets her needs.

Irrevocable Living Trusts

As distinguished from a testamentary trust that creates the trust at the death of a person setting up the trust, a living (or "inter vivos") trust is one created during the life of the person setting up the trust. Living trusts may be either revocable or irrevocable. In Texas, a trust is revocable unless made

irrevocable by the specific language of the instrument creating it. *Texas Law* has the effect of giving an automatic power of revocation to the person setting up the trust in every trust unless the trust instrument specifically provides otherwise.

As estate planning tools, irrevocable trusts generally are used to reduce the value of the trust founder's gross estate without giving the property outright to the trust beneficiary. Although the initial transfer of property to an irrevocable trust may be subject to gift taxes, any later increase in the value of the trust assets escapes estate tax in the trust founder's estate.

Revocable Living Trusts

The major disadvantage of irrevocable inter vivos or living trusts is their lack of flexibility. As an alternative, you may wish to create a revocable living trust. In Texas, a trust is automatically revocable unless made irrevocable by specific language of the instrument creating the trust. Generally, the person setting up the trust has greater control over the management of revocable trust assets. Under a revocable living trust, the person who established the trust has the right to revoke the trust and regain title to the property in the trust or to change or add to the trust as long as the change or addition does not enlarge the duties of the trustee without the trustee's consent. If the revocable trust was created by a written instrument, it may be added to or changed only by written instrument.

In a revocable living trust, legal title to the trust property passes to the trustee at the time of creation of the trust. Consequently, a revocable trust may be used to avoid the probate process. Therefore, a revocable trust is less public and often less expensive to administer than a probate estate. Keep in mind however that Texas provides a simple probate process that provides for "independent" administration of decedent's estates. If an independent executor is properly named in a Will, the only court involvement in the estate, absent litigation, is to "admit the Will to probate" (i.e., declare it to be valid), to officially appoint the independent executor, and to approve the Inventory and List of Claims. Therefore, probate avoidance alone would not be a compelling reason to create a revocable living trust.

For estate planning purposes, when living trusts are used as an alternative to a will, most, if not all, of a trust founder's property is contributed to the living trust. The trust founder may make specific dispositions of property not included in trust. But, in general, the will would leave any remaining property to the trust. The living trust would contain all of the dispositive provisions that apply to the trust founder's property. In the case of married couples, this means establishing marital deduction and unified credit or bypass trusts to take maximum advantage of estate tax minimization plans.

Revocable living trusts are not intended to achieve income tax savings. For federal income tax purposes, the income from a revocable living trust is taxable to the trust founder as if no trust had been established. The trust founder incurs income tax liability on the income from any portion of the trust to which the trust founder has the right to remove from the trust. Nor is the use of revocable trust intended to achieve any reduction of the trust founder's estate as with an irrevocable trust. A transfer of property to a revocable trust is not a completed gift for gift tax purposes. Therefore, the full value of property transferred to a revocable trust is included in the decedent's

gross estate if the power to revoke the trust is retained at death or was transferred within three years of death.

This information is not a substitute for a face-to-face meeting with an attorney. If you have further questions about setting up a trust you should meet with an attorney who specializes in the area of Estate Planning.